



No free lunch

A Grant Thornton white paper

Employee expense fraud is more serious than you may think.

Airline tickets. Tuition costs. Meals and entertainment. Hotel rooms. Individually, these expenses don't add up to much. Collectively, however, fraudulent reimbursement of common expenses accounts for 20% of cash misappropriation workplace fraud cases in Canada.¹

Think your business is immune? Think again. In its 2007 report, *Detecting Occupational Fraud in Canada*, the Association of Certified Fraud Examiners (ACFE) found that the typical Canadian organization loses 5% of its annual sales to fraud every year.² More critically, the incidence of expense fraud may be set to rise. In response to the economic downturn, some businesses cut back on controls that may have helped them detect internal fraud. Others are operating with fewer managers who have less time to provide appropriate oversight. Employees facing personal financial crises may be tempted to “fudge” their expense reports to recoup perceived losses. And as the economy begins to recover, they may believe they have more leeway to do so.

While the median loss of expense fraud is \$18,000,³ its danger extends far beyond financial repercussions. Failure to crack down on this unethical—and indeed criminal—behaviour blurs the line

between right and wrong. It creates a culture of entitlement that can extend across the business. And it can open the door to more significant corporate theft. For organizations of all sizes, the message is clear: You need to put processes in place to prevent expense fraud, detect if it's occurring within your organization and stop it in its tracks.

More than just pocket padding.

Before you can detect and prevent expense fraud, you need to understand the activities it encompasses. Generally, it's defined as any scheme where employees claim reimbursement for fictitious or inflated business expenses. It tends to manifest in one of four ways, although often more than one are present:

- Employees claim reimbursement for personal expenses by mischaracterizing them as business-related expenses. Although these claims may be as small as a dinner bill, they can extend to expensing personal vacations as business trips, charging unapproved purchases to a corporate credit card or requesting reimbursement for the purchase of personal computers or other technology.
- Employees inflate the amount of actual expenses and pocket the difference. This can include claiming expense reimbursements in excess of allowable per diems by splitting up the cost of individual items, adding gift certificates or prepaid cards to business purchases, adding amounts that were never paid to taxicab or meal receipts or inflating mileage totals on car travel allowances.

¹ Dr. Dominic Peltier-Rivest and the Association of Certified Fraud Examiners, “Detecting Occupational Fraud in Canada: A Study of its Victims and Perpetrators,” Association of Certified Fraud Examiners Inc., 2007, <http://www.acfe.com/documents/rtnn-canadian.pdf> (accessed September 30, 2009): 11.

² *Ibid.*, page 4.

³ *Ibid.*, page 11.

- Employees “double dip” by claiming legitimate expenses more than once. In these cases, employees may submit an original receipt in one month and submit a copy of the same receipt the next, collude with other employees to each bill for the same expense or request reimbursement on both an expense report and a credit card statement for the same purchase.
- Employees submit fake expenses by claiming reimbursement for purchases that never took place (e.g., cancelled airline tickets, conference registration fees, professional dues payments) or even manufacturing bogus receipts.

Pocket change? Hardly. In addition to mounting up to significant sums, expense fraud can result in costly and time-consuming investigations and lawsuits, lost jobs and even jail time. In April 2009, a former Newfoundland cabinet minister was found guilty of submitting falsified, forged or duplicitous expense claims while in public office. He was sentenced to two years less a day in jail amid allegations that he overspent \$467,653 from his constituency allowance account—more than five times the approved limit.⁴ Tellingly, a GlobalExpense survey conducted in the United Kingdom found 20% of staff admit to having exaggerated expense claims, with one in 10 saying they were likely to do so again.⁵

These are not the type of consequences organizations can afford, particularly in today’s shaky economic environment. To prevent your business from becoming a statistic, it’s time to take a good hard look at the internal controls you have in place to deter and detect workplace fraud.

The best defence is a good offence.

Because expense fraud can be an indicator of other frauds taking place, it’s important to articulate clear policies when it comes to this type of unacceptable conduct. While there are no one-size-fits-all solutions, the following steps can go a long way towards helping you prevent expense fraud.

Assess the risk.

As part of your corporate risk management processes, you should assess all forms of business risk on a regular basis. If you have not done so in the past, it’s time to add expense fraud to the categories of risk you review. In doing so, it can be helpful to understand the primary sources of occupational fraud risk in Canada. According to the ACFE,⁶ 42% of occupational frauds are committed by employees, as compared to 39% for managers and 19% for owners/executives. The departments that account for the highest percentage of occupational fraud cases are, in order, sales (17% of all cases), executive/upper management (15%), accounting (15%) and customer service (13%). Armed with this knowledge, you should be better placed to determine where your organization may be most susceptible to workplace fraud.

4 Canadian Broadcasting Company, “Former N.L. minister Byrne pleads guilty to fraud,” *Canadian Broadcasting Company*, <http://www.cbc.ca/canada/newfoundland-labrador/story/2009/04/17/byrne-sentenced-417.html> (accessed October 6, 2009).

5 Guy Logan, “Workplace fraud committed by one in five staff,” *PersonnelToday.com*, <http://www.personneltoday.com/articles/2008/11/25/48487/workplace-fraud-committed-by-one-in-five-staff.html> (accessed September 29, 2009).

6 Dr. Dominic Peltier-Rivest and the Association of Certified Fraud Examiners, “Detecting Occupational Fraud in Canada: A Study of its Victims and Perpetrators,” Association of Certified Fraud Examiners Inc., 2007, <http://www.acfe.com/documents/rtrn-canadian.pdf> (accessed September 30, 2009): 28.

Establish effective policies.

In many cases, expense fraud can be averted by implementing and enforcing effective policies and procedures. This starts by adopting a control environment that emphasizes ethical behaviour and features strong audit mechanisms. Here are some ways to achieve these goals:

- Add checks and balances to your expense review and approval process. Too often, businesses open the door to fraud by failing to segregate duties. To prevent this, appoint different people to review and approve expenses and conduct occasional internal audits of those functions.
- Spell out the consequences of an infraction. Decide in advance how you plan to deal with cases of expense fraud. Will the organization take disciplinary action? Will you commence litigation to recover the assets? Will you report all cases to the police? To help guide this decision, review any insurance policies that protect you from employee fraud or theft. In some cases, the policy requires you to report infractions to the police if you want coverage. Regardless of the course of action you choose, apply it consistently across the organization.
- Set clear expense reimbursement policies. Whether you reimburse actual and reasonable expenses, or set per diem rates, your employees should understand what is and is not allowed. Get granular. For instance, ask them to itemize not only the amount of a meal, but also list who attended and the purpose of the meal. Let them know what class of air or train travel is permissible for various types of trips. Mandate that they book their accommodation and/or travel with pre-approved hotels and travel agencies. Require them to use corporate credit cards—and then review the activity reports to spot potential discrepancies. Insist that they submit only original receipts and maintain these documents for audit purposes.

The consequences of inaction.

Cases of employee expense fraud can occur at all levels of an organization. “In one case we worked on, the owner of a company sold his business but continued on as president of the new company. Unfortunately, he continued to operate as if the company was his personal fiefdom, including running through literally hundreds of thousands of dollars in personal expenses for himself and his family. This wasn’t caught until the company’s business started declining and the parent company initiated an investigation,” notes Jonathan Dye of Heenan Blaikie LLP.

“The biggest issue from my perspective is that these cases can cost tens to hundreds of thousands, if not millions, of dollars to investigate and prosecute. To avoid these outcomes, it would be much better for companies to put in proper controls and oversight in the first place.”

Consider the tax consequences.

When establishing an expense reimbursement policy, it's also important to consider potential tax consequences. For instance, the Canada Revenue Agency (CRA) places limits on certain expense allowances. If you exceed these maximums, your employees may be deemed to have received a taxable benefit. The CRA also may deny expenses that are personal in nature since they were not incurred for the purpose of gaining or producing income for the business. Even business-related expenses may be denied if proper supporting documentation is not available for review by the CRA. And if the CRA does deny previously claimed expenses, your organization may find itself subject to a reassessment of previously filed corporate income tax returns, which could result in additional income taxes, penalties and interest.

Communicate and train.

Once you create an expense policy, communicate both its details and intent to all employees. Provide written instructions that managers can use to review expense submissions and spot anomalies. Also consider the benefits of regular ethics training. In addition to educating employees on the behaviours you expect them to adopt, this type of training can both limit the loss associated with fraud and reduce the time it takes to detect any fraud in progress.

Remain diligent.

Like horses and water, you can introduce an expense policy to your employees but you can't make them comply. To ensure your controls are working as anticipated, test their effectiveness on a regular basis. If your work processes or personnel change, review the controls again. Remember, too, that diligence begins even before you hire new staff. To cut down on the risk of expense fraud, conduct appropriate background checks. And when employees leave, don't leave things to chance. Remove their access rights to computer systems and keep an eye out for potential expense reporting discrepancies that may have preceded their departure.

Making the case for record keeping.

"Organizations should take care to maintain and organize complete records of employee expense reports, approvals and reimbursements for at least five years," says Angus McKinnon of Heenan Blaikie LLP. "Without these essential records, the organization's forensic auditors and litigation counsel will be unable to successfully pursue the fraudster."

Lead by example.

While there are no guarantees, fraud is much less likely to take place in an environment that values ethical behaviour and swiftly punishes infractions. By setting the right tone at the top, management plays a critical role in shaping a company's culture. If senior staff display an attitude of entitlement, this is likely to filter down throughout the organization. Conversely, if management makes it clear that fraud will not be tolerated—even if it appears financially insignificant—employees will be less likely to play fast and loose, and perpetrators will be more easily identified and caught.

Detecting fraud in action.

Beyond adopting prevention measures, businesses can better detect fraud in their own organizations if they understand how most frauds are discovered. According to the ACFE, 42% of workplace frauds are detected through tips, 20% are detected through internal and external audits, and 19% are detected by an organization's internal controls.⁷ This speaks to the wisdom of expanding your internal control environment to include fraud reporting hotlines and strong auditing practices.

In addition to encouraging the anonymous reporting of corporate misbehaviour, fraud hotlines can help prevent fraud by employees who fear being caught. As an added advantage, organizations with formal hotlines tend to experience lower median fraud losses and generally detect fraud more quickly than organizations without these mechanisms. The same is true for businesses that have internal audit departments, conduct surprise audits and bring in external auditors.

That said, these formal mechanisms don't replace careful observation of your employees. Red flags of expense account abuse do exist and should be monitored diligently.

Expense fraud warning signals: Questions to ask.

Is the employee living beyond his or her expected lifestyle or means?

Are you receiving expense claims without original receipts or supporting documentation?

Do documents appear to be altered?

Are the employee's expense reports much higher than other people in similar positions?

Have you received claims for unusual purchases?

Does the employee consistently submit his/her expense reports late?

If it happens to you.

Despite the best intentions, of course, expense fraud does still happen—which is why you should know how to respond if it happens to you.

Generally, you'll want to start with an investigation. If you are worried that the fraud may be more pervasive than you suspect, it makes sense to work with a third-party investigator who can help you identify all the perpetrators involved. Bringing in a third party may also help you keep the investigation private. This is important if there is a danger that the perpetrator may try to hide his or her tracks once an investigation begins. Keep in mind that expense fraud may signal that other frauds are

⁷ Ibid., page 20.

occurring, so your investigation should encompass the suspected employee's entire behaviour pattern. If the person committing expense fraud has subordinates, you may even want to examine the behaviour of other staff in the department to determine if there has been collusion and detect potential control weaknesses.

A next step would be forensic examination to determine the extent of the damages. In this phase, forensic accountants and forensic IT specialists would examine your accounting records, review personal emails, assess detailed expense reports, scan electronic records and otherwise extract any data that provides evidence of expense fraud. Forensic accountants also typically work with your legal counsel to prepare evidence briefs and help you build a case to support recovery of your losses.

Last, but not least, you need to decide how to deal with the infracting employee. Because expense fraud often involves relatively minor amounts of money, some companies are tempted to impose only a minor punishment. Before you go this route, consider the message this sends. Does it signal that you don't take expense fraud seriously? Does it demonstrate a lax stance towards fraud in general? To avoid this perception, many companies choose to punish perpetrators more severely — perhaps by seeking civil restitution, reporting their behaviour to authorities or terminating their employment. Although it may seem disproportionate, keep in mind that misconduct is only a matter of grade. If you are prepared to ignore the small stuff, you may have greater difficulty enforcing honesty for the bigger stuff.

The legal landscape

If your organization initiates legal proceedings in the case of employee fraud, there may be a number of legal remedies available to you. With a *Norwich* order, you can obtain information from third parties, such as financial institutions, to help trace the transfer of monies. *Mareva* injunctions and certificates of pending litigation can be used to freeze assets. Anton Pillar orders let you search a fraudster's premises to seize evidence before it can be destroyed.

"While the courts continue to view these as extraordinary remedies, they are available in appropriate cases and can prove invaluable in locating and recovering assets obtained through fraud," says Alexandra Mayeski of Heenan Blaikie LLP.

Act, don't react.

While many companies adopt more stringent anti-fraud measures after they have been victimized, this response does nothing to deter fraud in the here and now. To avoid becoming a victim in the first place, it's essential to assess your vulnerability to expense fraud proactively. Review the effectiveness of your anti-fraud measures. Ensure your policies align to best practices. And take steps to foster a culture that encourages honesty and integrity across the board.

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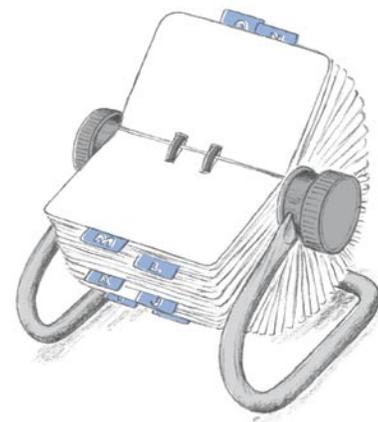
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